MINUTES
BOARD OF TRUSTEES OF THE
PUBLIC EMPLOYEES' RETIREMENT FUND
143 West Market Street, Suite 500
Indianapolis, Indiana 46204
February 24, 2006

REGULAR SESSION

Board Members Present
Chuck Schalliol, Vice Chair, Office of Management & Budget
Kathy Ettensohn
Bob Welch
Regina Overton
Matt Murphy

Board Members Absent
Ken Cochran, Chair

Others Present
Tony Armstrong, Office of Management & Budget
Doug Todd, McCready & Keene
Elaine Beaty, McCready & Keene
Doug Kryscio, Mercer Investment Consulting
Iliana Nikolova, Mercer Investment Consulting
John Piper, Nationwide Retirement Solutions
Matt Herrmann, Nationwide Retirement Solutions
Karl Browning, Indiana Office of Technology
Michelle Hartman, Clifton Gunderson
Jim Hartman, Clifton Gunderson
Walt Kelly, Clifton Gunderson
Greg Strack, State Budget Agency

PERF Staff Present
David Adams, Executive Director
Terry Magid, Chief Operating Officer & Deputy Director
Dave Huffman, Chief Technology Officer & Deputy Director
Andrea Unzicker, General Counsel
Michael Henning, Director of Human Resources
Jeff Carter, Director of Communications
Shawn Wischmeier, Chief Investment Officer
Will Frayer, Staff Attorney
Cathleen Koontz, Outreach Representative
Erin Hankins, Assistant to the Executive Director
Jayelynn Willman, Executive Assistant to the Board

Meeting called to order at 1:00pm by Tony Armstrong.

I. Approval of Minutes

MOTION duly made and carried to approve the minutes from the December 16, 2005 board meeting.

Proposed by:	***Bob Welch***
Seconded by:	***Kathy Ettensohn***
Votes:	***5 in favor, 0 opposed, 0 abstentions***

II. Old Business

- SBOA Audit Findings

Terry Magid reviewed the State Board of Accounts (SBOA) audit findings with the board. He announced that PERF reduced the number of audit findings by 50% and completed the audit four months ahead of last year's schedule.

PERF has contracted with Ernst & Young to analyze the remaining findings and develop a plan for resolution. The area of focus is on internal controls. Once PERF has reviewed a report prepared by Ernst & Young appropriate steps will be taken to resolve the issues.

Terry Magid communicated that PERF leadership is committed to resolving the findings. He also stated that building a relationship/partnership with the SBOA is an important step in the process.

Kathy Ettensohn noted that when internal control weaknesses exist either opportunities exist for fraud or there are system deficiencies that can cause errors. From the discussions, she indicated that PERF's internal control issues revolve around system deficiencies. Mr. Magid concurred and noted that the SBOA found no fraudulent transactions. The issues revolve around process or system issues that may cause errors.

- Performance Management Update

Michael Henning provided the Board with a Performance Management update. In January 2006, PERF implemented their Performance Management System. The first step of the process was completed at the end of January. This process was a new experience for many of PERF's employees. Overall 110 reviews were conducted.

Tony Armstrong inquired if anyone receiving less than 2% was surprised. Mr. Henning noted that there were very few surprises. He credits this to the fact that PERF began introducing metrics and conducting meetings to discuss the metrics months in advance of the reviews.

Mrs. Ettensohn asked how many people reviewed each employee. Mr. Henning noted that the reviews were prepared in advance of the discussions. The reviews were then seen by the next level of management for their assessment. Only the employees' supervisor conducted the review.

Mr. Henning explained that the next step was to set up performance improvement plans for the 40 people who had at least one element of their review that needed improvement.

Bob Welch inquired which employee scored exceptional on their review. Mr. Adams introduced Cathleen Koontz with the Outreach Department to the board as the individual who received an exceptional performance rating. She is responsible for assisting members and employers with education about retirement planning.

Matt Murphy asked where PERF's 17 supervisors and managers ranked among the 110 performance reviews conducted. Mr. Henning stated that an area of improvement is in the area of middle management. To address these issues, PERF management will be attending management training in conjunction with the Department of Revenue.

Going forward, PERF will continue to manage improvement plans for consistency, effectiveness and impact. This year, PERF is going to have two more interim reviews without salary increases to keep both managers and employees focused and familiar with the process. In the fall of 2006, PERF will conduct a performance review with salary adjustments tied to the outcome. PERF management will use this information to determine who is ready to take on additional responsibility and create development programs for them.

Mr. Henning is also working on a new compensation plan. Currently PERF does not have a formal plan for salary ranges.

III. Executive Director Report

Before discussing his report, David Adams communicated that one of PERF's employees, Elizabeth Curley, who started with PERF in 1992 and worked in the Accounting Department, had passed away.

Mr. Adams announced that a report published in Pensions & Investments indicated that PERF had moved from the 98th to 90th largest pension system in the country based on total assets. This report compared both public and private pension systems.

Mr. Adams distributed a copy of the Comprehensive Annual Financial Report for 2005. Previously, this publication was released in the middle of July each year. This year PERF was able to produce it 5 ½ months ahead of schedule.

Mr. Adams reviewed the first half of fiscal 2006 PERF Scorecard results with the board. In terms of statewide initiative, the numbers were similar to those presented at the December board meeting. Annual savings to date are $1.4 million and PERF has achieved a one time savings and efficiency gain of $183,000. Mr. Adams also reported that PERF has achieved $340,000 in competitive sourcing savings. This savings is a reflection of prudent management of the fund's resources. From a financial performance standpoint, PERF finished the year at $13.3 billion. PERF increased the fund $900 million.

Mr. Adams discussed PERF's continued commitment to customer service:

- Over the past six months PERF has significantly reduced the time to receive a refund by 30% and the time between retirement date and first check by 15%.
- PERF created the "Bridge to Retirement" brochure. The brochure provides PERF members with a process that will assist them in their retirement planning.
- Customer satisfaction has increased 29%. PERF is receiving feedback from members, employers and legislature stating that they can tell a difference in the speed and responsiveness of PERF.
- PERF launched PERF interactive in November 2005. Since November, over 7000 members have registered.
- The first electronic employer certification had occurred within the last two weeks.
- The Governor initiated a new public service award. This award recognizes state employees who have made a significant contribution to improving government efficiency and customer service. Of the 33,000 employees only 14 individuals were recognized. William Frayer, PERF's Staff Attorney was a recipient of this prestigious award. Mr. Frayer was instrumental in turning $14 million in assets over to four counties, resulting in reduced contribution rates.

- In an effort to better serve our members, PERF has created a 'Service Excellence Team'. This team will focus on communication with members and is responsible for problem resolution and quick responsiveness with employers and members.

Mr. Adams outlined some of the major initiatives to take place between now and June 30, 2006 that will help improve PERF.

- PERF will continue to look for enhanced education for employers and members as well as enhancements to the website.
- PERF will continue to look for opportunities to operate more efficiently. As an example, PERF was able to find an organization inside state government that has capacity to do all printing at lower costs. Once fully implemented, the fund will save in excess of $100,000.
- The technology team is working on the reimplementation of SIRIS.

IV. <u>New Business</u>

- **Legislative Update**

  Andrea Unzicker reviewed the list of bills with the board members. Mr. Adams noted that during this legislative session, PERF is taking a proactive approach. PERF is working with the legislature to resolve administrative issues before they occur.

  Mrs. Ettensohn inquired regarding the 13th check and why it's awarded. Mr. Adams explained that the legislature from time to time will award a 13th check. Mr. Adams pointed out that the actuarial assumptions in the liability analysis do account for the Cost Of Living Allowance (COLA), but not a 13th check. The PERF fund as of July 1, 2005 had an unfunded liability of $623 million.

- **Audit & Budget**

  <u>Financial Update</u>

  Mr. Magid provided the board with a financial update. PERF's actual expenses are tracking well below budget. PERF is going to reallocate between wages/salary and the supplemental staff line items to better reflect personnel costs.

Clifton Gunderson Findings

Mr. Magid introduced Walter Kelly, Michelle Hartman and Jim Hartman from Clifton Gunderson. Clifton Gunderson has validated various types of PERF benefit payments paid from April 2002 through June 30, 2004.

Clifton Gunderson has reviewed 11,000 accounts from April 2002 to June 30, 2004. The results of their analysis indicate that 56.5% of payments had an error. The reasons for these errors are reflected in three broad categories: system issues, human error, and process deficiencies. To address these issues, Mr. Magid explained that PERF has updated and fixed the system, has implemented audit processes for benefit payments and has implemented a final benefit audit and analysis process that occurs six to twelve months after the initial retirement benefit is paid. This is done to ensure all wages and contributions have been included in the benefit.

PERF will issue an RFP to correct the benefit payments and correct the problems. Mr. Magid also indicated that an RFP would be issued to address benefit payments from July 1, 2004 forward. Mr. Magid indicated that monies were available within the current budget to address both of these RFP's.

- **Investments**

Investment Update

Shawn Wischmeier provided the board with an investment update. For calendar year ending December 31, 2005, PERF had a 7.7% return, beating the 6.7% benchmark by 1%. Mr. Wischmeier indicated that the Consolidated Retirement Investment Fund had surpassed the $13 billion mark by year end. January performance was exceptional and puts the CRIF at approximately $13.8 billion.

Mr. Wischmeier noted that one of PERF's current fixed income managers, Black Rock, has merged with Merrill Lynch. PERF has reviewed the status with Black Rock and does not expect any changes in the team or direction. PERF, at this point, has no concern.

Mr. Welch asked Mr. Wischmeier to update the board on Hughes Capital Management. Mr. Wischmeier noted that his team is currently and will continue to monitor Hughes Capital Management, but recommended no changes at this time.

Investment/Board Roadmap

After reviewing the investments, Mr. Wischmeier noted that PERF's current portfolio is on a solid foundation. Mr. Wischmeier noted that PERF will focus on tweaking the portfolio to achieve higher risk-adjusted returns.

Mr. Wischmeier discussed highlights from calendar year 2005. In regards to the broad portfolio, PERF had international securities lending approved and PERF converted to standardized benchmarks. PERF also approved two alternative investments at the end of 2005.

Mr. Wischmeier indicated that an Asset Liability Study will be performed to review the entire portfolio. Mercer will be conducting the study. This study may lead to changes in the Investment Policy Statement (IPS) for PERF.

Currently, PERF has a 5% allocation to alternatives in their portfolio. With $13 billion, PERF should have $650 million invested in alternatives. As of September 30, 2005, PERF has approximately $50 million invested or 7% of the $650 million. This is short of PERF's original plan which was to be fully invested in this asset class by 2008.

Mr. Schalliol asked how the target allocation for alternatives was established. Mr. Wischmeier explained that the target allocation is specified in PERF's IPS that was approved by a previous board. That target allocation could change depending on the results of the Asset Liability Study.

Mr. Welch, referring to a hand-out, noted that the chart does not show committed funds. Mr. Wischmeier stated PERF currently has approximately $200 million in committed capital. The amount of invested capital is growing even though PERF has not approved any new deals. Mr. Adams noted that the current IPS does not mention committed capital. The IPS specifically states invested capital.

Mr. Schalliol commented that many universities are putting allocations for alternative investments much higher than 5%. Mr. Welch noted that the Asset Liability Study will help dictate how much PERF should or should not put towards alternatives. Mr. Adams noted that there is also the opportunity to reduce or maintain contribution rates for the employers.

Mr. Wischmeier discussed methods to increase the pace of alternative investments. One option for PERF is to focus on larger deals that average around $50 million. At that rate, the expected time to complete the target allocation is approximately five years. Historically, the average deal size for PERF has been approximately $25 million.

Investing strictly in larger deals would preclude investments in Indiana. To help address this issue, Mr. Wischmeier discussed the creation of a targeted fund. PERF would allocate up to $100 million to this fund that would target Indiana opportunities. This fund would operate similar to a standard private equity investment. PERF would hire a general partner to perform the duties of the fund and PERF would be a limited partner to the fund.

The offices of the fund would ideally be located in downtown Indianapolis and would be managed by a general partner located in Indiana. Organizations throughout Indiana could present opportunities for funding. The primary focus of this fund is return, but would create a mechanism for 'smaller' opportunities to be evaluated that otherwise would not be evaluated due to size constraints. Mr. Wischmeier explained that $100 million is a sizable enough position in the portfolio to avail ourselves of the opportunities without adverse concentration.

Mrs. Ettensohn asked Mr. Wischmeier to explain why we would hire an external general partner as opposed to building the resources internally. Mr. Wischmeier stated that a general partner with a strong national expertise would be more qualified to manage this program. It wouldn't be cost effective for PERF to build the internal ability to do this same level of work.

Mr. Murphy commented that it would be helpful for the board to understand which other states have undertaken a similar program. Mr. Wischmeier agreed that an analysis of other state programs would be performed and reported to the board as part of any request to approve the discussed fund.

Mr. Wischmeier stated that there is still a lot of work to do prior to presenting specific recommendations to the board.

Mr. Wischmeier indicated that PERF's IPS requires board notification when a rebalancing occurs. In early 2006, PERF rebalanced to generate cash necessary for fund expenses. Mr.

Wischmeier provided a document, prepared according to the IPS, signed by Mercer and countersigned by Mr. Schalliol.

Mr. Wischmeier noted that PERF is planning a board retreat to discuss various issues. He noted that each board member had a questionnaire in their board book that listed topics of interest to discuss at the board retreat. He asked that each board member rank their top three choices and those topics would round out the board retreat agenda.

- **Compensation for Executive Director**

  Mr. Armstrong noted that the board sets the compensation for the Executive Director. The Executive Branch management received a 2% increase in salary for 2006.

MOTION duly made and carried to approve a 2% increase for the Executive Director.

Proposed by: ***Kathy Ettensohn***
Seconded by: ***Chuck Schalliol***
Votes: ***5 in favor, 0 opposed, 0 abstentions***

Mr. Schalliol commented that Mr. Adams has done an exceptional job, so the fact that the board is only approving 2% is just to keep him consistent with what other appointed executives have received and not a reflection of his performance.

V. Date of Next Meeting

April 21st, 2006 at 1pm

VI. Adjournment

Adjourned at 2:56pm.